

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ALTERNATIVE RATE FILING ADJUSTMENT) CASE NO.
OF BLUEGRASS GAS SALES, INC.) 2011-00364

ORDER

On September 2, 2011, Bluegrass Gas Sales, Inc. ("Bluegrass") tendered its application requesting that the Commission approve its proposed increase in its base rates for providing natural gas service pursuant to 807 KAR 5:076, the Commission's regulation under which smaller utilities may use an Alternative Rate Filing ("ARF") process. While its annual revenues and number of customers both slightly exceeded the maximum amounts allowed under the ARF regulation, Bluegrass sought, and was granted, a deviation permitting it to file its application pursuant to the ARF regulation. Because of filing deficiencies in the application, the Commission did not accept the case as filed until Bluegrass cured the deficiencies on September 26, 2011.¹ Having performed a limited financial review of Bluegrass's financial operations, Commission Staff ("Staff") has prepared the attached report which contains its findings and recommendations regarding the proposed base gas rates.

Finding that Bluegrass should be afforded the opportunity to respond to Staff's findings and recommendations, the Commission HEREBY ORDERS that:

¹ Bluegrass's application did not identify how notice of its proposed rate increase was provided to its customers. In its September 26, 2011 response to the Commission's deficiency letter, Bluegrass stated that notice was given in local newspapers published in the six counties in which it provides service.

1. All parties shall have 10 days from the date of this Order to file with the Commission written comments, if any, on the findings and recommendations contained in the attached Staff Report and to request an informal conference with Staff or a formal hearing in this matter.

2. A party's failure to file with the Commission written objections to a finding or recommendation contained in the Staff Report within 10 days of the date of this Order shall be deemed as agreement with that finding or recommendation and a waiver of any right to object to that finding or recommendation.

3. No later than 10 days from the date of this Order, each party shall notify the Commission in writing whether this matter may be submitted for decision based upon the existing record without hearing.

4. A party requesting a hearing in this matter shall specifically identify in its written request for a hearing all objections to the findings and recommendations set forth in the Staff Report and shall provide a brief summary of issues that it expects to present at the hearing.

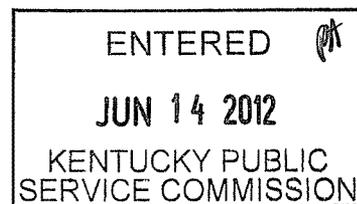
5. Unless all parties request that this matter be submitted for decision upon the existing record, an informal conference shall be held in this matter on June 28, 2012 at 2:00 p.m., Eastern Daylight time, in the Commission's offices at 211 Sower Boulevard, Frankfort, Kentucky.

6. Unless all parties request that this matter be submitted for decision upon the existing record, a formal hearing in this matter shall be held in the Commission's offices at 211 Sower Boulevard, Frankfort, Kentucky on July 12, 2012, beginning at 9:00 a.m., Eastern Daylight time.

7. Bluegrass shall publish notice of the scheduled hearing in accordance with 807 KAR 5:076, Section 11, no more than 21 days and no less than seven days before the day of the scheduled hearing.

8. If the Commission does not receive any written comments, request for an informal conference, or a formal hearing within the 10 days of the date of this Order, this case shall stand submitted to the Commission for decision based on the existing record.

By the Commission



Commissioner Breathitt Abstains.

ATTEST:

Carolyn D. Greenwell for
Executive Director

STAFF REPORT
BLUEGRASS GAS SALES, INC.
CASE NO. 2011-00364

Commission Staff ("Staff") performed a limited financial review of Bluegrass's test year, calendar year 2010.¹ The scope of the review was limited to obtaining information on whether test-year operating revenues and expenses were representative of normal operations and whether Bluegrass's proposed adjustments are reasonable. Immaterial or insignificant discrepancies were not pursued and are not addressed herein.

Jeff Shaw and Leah Faulkner of the Commission's Division of Financial Analysis performed this review. This report summarizes Staff's review and recommendations. Ms. Faulkner is responsible for the pro forma revenue adjustment, the adjustment to purchased gas, and the development of the base rates. Mr. Shaw is responsible for the remaining pro forma expense adjustments and the revenue requirement calculation.

In its application, Bluegrass reported total revenues of \$473,373 and total expenses of \$616,786 for calendar year 2010 resulting in a net loss of \$133,364.² The Commission typically uses an operating ratio³ to determine revenue requirements for small, private utilities. This is done primarily when there is no basis for a rate-of-return determination or the cost of the utility has fully or largely been funded through receipt of contributions. Bluegrass used an 88 percent operating ratio in its application, which

¹ The on-site field visit by Mr. Shaw was conducted on November 29, 2011.

² \$129,192 of Bluegrass's loss was due to under-recovered purchased gas expenses through its Gas Cost Adjustment ("GCA"). A subtraction error caused Bluegrass's test-year loss to be understated by \$49 in its application. Minor differences (\$1 or \$2) in Appendices B and C are due to rounding.

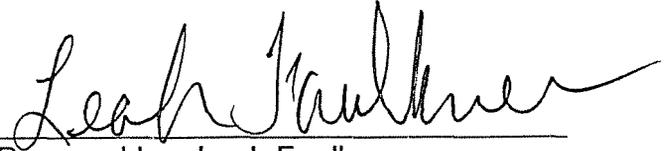
³ Operating Ratio, for gas utilities, is defined as the ratio of expenses, including depreciation and taxes other than income taxes, less purchased gas expenses, to gross revenues.

those rates. The gas cost rate in Appendix D is that approved by the Commission effective April 1, 2012.

Signatures



Prepared by: Jeff Shaw
Policy and Research Consultant
Division of Financial Analysis



Prepared by: Leah Faulkner
Rate Analyst, Electricity and Gas Rate
Design Branch
Division of Financial Analysis

Staff finds appropriate to determine Bluegrass’s revenue requirement. This will allow Bluegrass sufficient revenues to cover its reasonable operating expenses and provide for reasonable equity growth.

Using an 88 percent operating ratio, Bluegrass calculated a base rate revenue requirement of \$362,278, \$113,904 (45.9 percent) over normalized base rate revenues of \$248,374.⁴ With its recommended adjustments and using an 88 percent operating ratio, Staff calculated a base rate revenue requirement of \$346,575, \$98,201 (39.5 percent) over normalized base rate revenues. Table 1 is a comparison of Bluegrass’s requested revenue requirement to the revenue requirement recommended by Staff.

Table 1: Determination of Revenue Requirement		
	Bluegrass	Staff
Pro Forma Operating Expenses	\$ 330,556	\$ 296,567
Divide by: Operating Ratio	÷ 88%	÷ 88%
Revenue to Cover Operating Ratio	\$ 375,632	\$ 337,008
Less: Operating Expenses	- 330,556	- 296,567
Required Net Operating Income	\$ 45,056	\$ 40,441
Multiplied by: Tax Gross-up Factor	x 1.23839009	X 0.00
Required Net Operating Income Before Income Taxes	\$ 55,821	\$ 40,441
Add: Pro Forma Operating Expenses	330,556	296,567
Interest Expense	14,700	15,200
Imputed Shareholder Income Taxes	\$ 22,625	\$ 0
Total Revenue Requirement	\$ 367,911 ⁵	\$ 352,208
Less: Other Operating Revenues	- 5,633	- 5,633
Revenue Requirement - Base Gas Rates	\$ 362,278	\$ 346,575
Less: Test-Period Revenue - Base Gas Rates	- 248,374	- 248,374
Requested Increase - Base Gas Rates	\$ 113,904	\$ 98,201

⁴ Bluegrass failed to include Required Net Operating Income Before Income Taxes in calculating its Total Revenue Requirement (“TRR”). Correcting for that would increase its TRR to \$423,702.

⁵ Bluegrass also understated its TRR by using actual test-year interest expense rather than pro forma interest expense. Correcting for that would increase its TRR to \$424,202.

Staff's recommended revenue requirement from gas sales will allow Bluegrass to cover its pro forma operating expenses, meet its debt service requirements, and provide for future equity growth. Because they would produce annual revenues greater than the revenue requirement determined reasonable in this report, Staff recommends that the rates proposed by Bluegrass be denied. Staff developed its proposed base rates by applying Bluegrass's proposed \$10 customer charge to the actual number of 2010 bills, using information Bluegrass provided. Bluegrass's application had used 6,564 bills, however, upon review of Bluegrass's monthly billing information, Staff determined that the actual number of bills was 6,978, with a resulting average customer level of 582. (This average of 582 customers is supported by the 24-month average number of bills for the period ending September 30, 2011, provided by Bluegrass during the November 2011 filed review.) Customer charge revenues were subtracted from the base rate revenue requirement and the remaining required revenues were divided by 2010 sales volumes.⁶ Staff recommends that the \$10 customer charge be approved as proposed in order to provide stability to Bluegrass's revenues, especially during summer months when sales are at their lowest and when Bluegrass experiences seasonal disconnects. Staff also recommends that Bluegrass investigate the impact of establishing a seasonal reconnect fee so that customers who disconnect after the end of the heating season would pay the foregone customer charge revenues when they reconnect. The second set of rates in Appendix D to this report will produce the recommended base rate revenue requirement of \$346,575. Staff recommends that the Commission accept

⁶ Staff prepared two sets of rates, one that reflects no increase in salaries and wages (or payroll taxes) and one that reflects Staff's recommended increase in salaries and wages (and payroll taxes).

APPENDIX A
 STAFF REPORT, CASE NO. 2011-00364
 BLUEGRASS'S PROPOSED
 PRO FORMA OPERATING STATEMENT

	2010	Pro Forma Adjustments	Pro Forma Operations
Operating Revenues:			
Total Gas Service Revenues	\$ 467,740	\$ (219,366)	\$ 248,374
Miscellaneous Service Revenues	5,633	0	5,633
Total Gas Operating Revenues	\$ 473,373	\$ (219,366)	\$ 254,007
Operating Expenses:			
Natural Gas Purchases	\$ 313,335	\$ (313,335)	\$ 0
Gas Transportation	35,222	(35,222)	0
Purchased Gas Expense	\$ 348,558	\$ (348,557)	\$ 0
Mgmt. / Acct. / Admin. Services	\$ 12,000	\$ 12,000	\$ 24,000
Salaries and Wages	74,670	15,000	89,670
Payroll Tax Expenses	6,584	1,298	7,882
Bank Fees, Postage, Misc.	3,195	800	3,995
Office Supplies & Expenses	2,524	0	2,524
Office Rent	3,000	11,400	14,400
Repairs and Maintenance	9,543	7,500	17,043
Insurance – Liability & Property	18,427	2,000	20,427
Insurance – Health	25,990	1,300	27,290
Vehicle Lease	2,620	5,580	8,200
Truck Maintenance / Gasoline Exp.	19,885	3,000	22,885
Taxes – Property & Use	15,673	1,000	16,673
Utilities	4,689	100	4,789
Insurance – Workers Comp.	1,221	100	1,321
PSC Assessment	2,724	250	2,974
Professional Fees	7,160	6,000	13,160
Outside Services	4,801	4,000	8,801
Dues, Fees and Licenses	1,173	0	1,173
Bad Debt Expense	3,504	500	4,004
Depreciation Expense	24,146	0	24,146
Interest Expense	14,700	500	15,200
Total Expenses	\$ 606,787	\$ (276,230)	\$ 330,556
Net Income	\$ (133,364)	\$ 56,864	\$ (76,549)

APPENDIX B
STAFF REPORT, CASE NO. 2011-00364
STAFF'S PROPOSED
PRO FORMA OPERATING STATEMENT

	2010	Pro Forma Adjustments	Adj. Ref.	Pro Forma Operations
Operating Revenues:				
Total Gas Service Revenues	\$ 467,740	\$ (219,366)		\$ 248,374
Miscellaneous Service Revenues	5,633	0		5,633
Total Operating Revenues	<u>\$ 473,373</u>	<u>\$ (219,366)</u>		<u>\$ 254,007</u>
Operating Expenses:				
Other Gas Supply Exp:				
Natural Gas Purchases	\$ 313,335	\$ (313,335)		\$ 0
Gas Transportation	35,222	(35,222)		0
Purchased Gas Expense	<u>\$ 348,558</u>	<u>\$ (348,557)</u>		<u>\$ 0</u>
Mgmt. / Acct. / Admin. Services	\$ 12,000	\$ 5,022	(a)	\$ 17,022
Salaries & Wages	74,670	8,453	(b)	83,123
Payroll Tax Expenses	6,584	745	(c)	7,329
Bank Fees, Postage, Misc.	3,195	800		3,995
Office Supplies & Expenses	2,524	0		2,524
Office Rent	3,000	7,710	(d)	10,710
Repairs and Maintenance	9,543	0	(e)	9,543
Insurance – Liability & Property	18,427	2,000		20,427
Insurance – Health	25,990	(1,200)	(f)	24,790
Vehicle Lease	2,620	5,580		8,200
Truck & Gasoline Expense	19,885	2,442	(g)	22,327
Taxes – Property & Use	15,673	1,000		16,673
Utilities	4,689	100		4,789
Insurance – Workers Comp.	1,221	100		1,321
PSC Assessment	2,724	86	(h)	2,810
Professional Fees	7,160	1,000	(i)	8,160
Outside Services	4,801	4,000		8,801
Dues, Fees, & Licenses	1,173	0		1,173
Bad Debt Expense	3,504	0	(j)	3,504
Depreciation Expense	24,146	0		24,146
Interest Expense	<u>14,700</u>	<u>500</u>		<u>15,200</u>
Total Expenses	<u>\$ 606,787</u>	<u>\$ (310,220)</u>		<u>\$ 296,567</u>
Net Income	<u>\$ (133,414)</u>	<u>\$ 90,854</u>		<u>\$ (42,560)</u>

APPENDIX C
STAFF REPORT, CASE NO. 2011-00364
STAFF'S RECOMMENDED
PRO FORMA ADJUSTMENTS

a. Management/Accounting/Administrative Services. Bluegrass is proposing to reflect an increase, from \$12,000 to \$24,000, in its expense for the management, accounting, tax, administrative, and regulatory services it receives from Home Office, Inc. ("Home Office"). Home Office, a Louisville-based accounting and management company with whom Bluegrass shares common ownership, provides 100 percent of the above-identified services to Bluegrass, which engages no other outside firms for these services. According to Exhibit # 2 of Bluegrass's application, "[t]he approved rate from prior rate adjustments was \$1,000 per month." A review of the Staff Report and Commission's Final Order in Bluegrass's last rate case, Case No. 1998-00305,¹ confirms that \$3,000 in "officer compensation payments" in the last quarter of the test year were recorded in Administrative and General Salaries. While the terminology may have been different, a \$12,000 fee was included for recovery through Bluegrass's base rates.

In its application, Bluegrass states that Home Office has been required to devote more time to Bluegrass due to its stressed financial condition and the need to maintain daily operations as the utility has continued to grow.² While it has not historically tracked the time required for providing services to Bluegrass, Home Office provided an estimate of the hours involved with many of the services it provides. Its services include

¹ Case No. 1998-00305, In the Matter of the Alternative Rate Filing for Bluegrass Gas Sales, Inc. (Ky. PSC Jan. 7, 1999).

² Bluegrass's number of customers increased by 15 percent while its Mcf sales grew by more than 50 percent over the four years ending 12/31/2010.

preparation of the following for Bluegrass: (1) Annual report filed with the Commission; (2) Annual state property tax return; (3) Annual federal and state Subchapter S income tax returns; (4) Quarterly GCA filings with the Commission; (5) Monthly billing of Bluegrass's non-residential customers; (6) Preparation of the ARF filing which is the subject of this case; and (7) Various administrative and accounting functions as the need arises.

As the time of Home Office personnel has not been tracked, there is no documentation of how much time is involved in the work it performs for Bluegrass; therefore, Staff cannot recommend that the Commission accept the proposed \$12,000 increase. However, based on Commission actions in previous cases when a small utility has gone several years between rate cases, Staff will recommend an adjustment based on the increase in the Consumer Price Index ("CPI") since the test-year of Bluegrass's last rate case as a guide for determining reasonable increases in salaries, wages, and other types of compensation over the time between cases.³ The change in the CPI from the March 1998 test year in Bluegrass's prior rate case through April 2012 is 41.85 percent.⁴ Applying this percentage to the \$12,000 that was previously included in Bluegrass's revenue requirement for recovery through its base rates produces \$17,022. This amount, which Staff recommends be included in determining Bluegrass's

³ The Commission has used the CPI as a guide in determining the reasonableness of salary and wage increases in at least two small gas utility rate cases. See Case No. 2003-00171, A Review of the Rates of Elam Utility Company, Inc. Pursuant to the Decision to Approve the Financing Requested in Case No. 2001-00324 (Ky. PSC Sept. 18, 2003) and Case No. 2008-00392, Application of Citipower, LLC for Rate Adjustment for Small Utilities Pursuant to 807 KAR 5:076 (Ky. PSC Apr. 3, 2009).

⁴ $(230.85 - 162.75) / 162.75 = 41.85$ percent.

revenue requirement, results in an adjustment of \$5,022 to increase the test-year level of expense in Bluegrass's pro forma operating statement.

b. Salaries and Wages. Bluegrass's test-year expense for employee salaries and wages was \$74,670. Based on its inability to award substantive pay increases in recent years due to its cash flow constraints, Bluegrass proposes to implement a 20 percent increase in conjunction with receiving a Commission decision in this case.⁵ Bluegrass stated that it believes its current employees' loyalty and longevity supports such an increase, which, according to the application, would equate to having given annual increases of roughly 3.75 percent over the past five years. The corresponding adjustment proposed by Bluegrass is an increase of \$15,000 to \$89,670.

It is not the Commission's normal practice to recognize pay increases that occur so far after the end of a utility's test year. Nor is it the Commission's practice to recognize pay increases that are, ostensibly, tied to a utility being awarded a rate increase that will permit it to afford those increases.⁶ However, there are safety and reliability issues to consider in the case of a gas utility and those considerations are best addressed when the utility has competent and experienced employees. With that in mind and under the unusual circumstances of this case, namely, the length of time during which Bluegrass's employees have received virtually no pay increases, Staff believes this is an appropriate time to recommend that the Commission depart from its

⁵ Bluegrass's application documented the lack of increases with a payroll summary report and its federal W-3 wage and tax statements for the years 2007-2010.

⁶ It is easy to envision situations in which, under such circumstances, a utility does not follow-through with the planned pay increases but uses the portion of the rate increase that was intended to fund the pay increases for other purposes.

normal practice, on the condition that, in response to the Commission's Final Order, the chief officer of Bluegrass submit a signed affidavit stating that the pay increases authorized by the Commission were implemented for its employees within 90 days of the issuance of that Order.⁷

While Staff recommends that the Commission include pay raises for Bluegrass's employees in the eventual rate increase, it is not recommending that the Commission include 20 percent increases as proposed by Bluegrass. The Commission has carefully scrutinized salary and wage increases in recent years, particularly in recognition of the economic conditions that have existed since 2008.⁸ Given the circumstances, which are the length of time since Bluegrass's most recent rate case and the time over which its employees have had almost no pay increases, Staff will turn again to the CPI as a guide. Based on the increase in the CPI over the past 60 months (May 2007 - April 2012) of 11.32 percent,⁹ that percentage is the increase that Staff recommends be awarded Bluegrass's employees. That will result in an adjustment to increase test-year salaries and wages by \$8,453, from \$74,670 to \$83,123.

c. Payroll Tax Expenses. Bluegrass proposed to increase its payroll tax expenses by approximately 20 percent to match its proposed increase in salaries and wages. Based on its recommended increase in Bluegrass's salaries and wages, Staff

⁷ Staff recommends that the Commission authorize rates that include no increase in salaries and wages (or the related in payroll taxes) in its Final Order and authorize rates that include increases in salaries, wages, and payroll taxes only after receiving the affidavit from Bluegrass's chief officer.

⁸ See Case No. 2010-00167, Application of East Kentucky Power Cooperative, Inc. for General Adjustment of Electric Rates (Ky. PSC Jan. 14, 2011) and Case No. 2010-00476, Application of Water Service Corporation of Kentucky for an Adjustment of Rates (Ky. PSC Nov. 23, 2011).

⁹ $(230.085 - 206.686) / 206.686 = 11.32$ percent.

recommends the same 11.32 percentage increase in payroll tax expense. The resulting adjustment is an increase of \$745 from the test-year amount of \$6,584 to \$7,329.

d. Office Rent. For the test year, Bluegrass's expense for office rent was \$3,000. According to the application, Bluegrass rents office space in Center, Kentucky, in Metcalfe County, from its minority shareholder at a cost that is well below market for the local area and has done so for several years. Bluegrass described the property as "[o]ffice space and storage for equipment...which exceeds 2,100 square feet." Based on local rental rates of \$6.00 to \$7.00 per square foot/year, it proposed an adjustment to increase its office rent expense by \$11,400, to \$14,400 annually (\$1,200 per month).

In the information it provided Staff subsequent to Staff's field review, Bluegrass included rental listings for properties available in the Glasgow, Kentucky Metropolitan Statistical Area ("MSA"), as no current commercial rental activity data was available for Metcalfe County. As Center, Kentucky is part of the Glasgow MSA, Bluegrass provided commercial rental rates for that area, which ranged from \$5.10 to \$16.00 per square foot/year. In the letter that accompanied those rental listings, Bluegrass stated its understanding that a discount should be applied to the Glasgow MSA rental rates due to the rural nature of its location in Center.

Transactions between a jurisdictional utility and an owner of that utility are often a point of concern for the Commission. Their less-than-arms'-length nature can, and often does, raise questions about whether an owner is trying to be enriched at the expense of the utility's customers. Fortunately, in this situation, the item in question, rent expense, is one that can be judged against a local market to assist in determining if the cost is reasonable. The range of the rental rates for the Glasgow MSA appears

quite broad, with the upper end, \$16.00, being more than twice the local rental rate of \$6.00 to \$7.00 on which Bluegrass based its proposed increase. With such a broad range, and sharing Bluegrass's belief that a discount should be recognized for Center's rural location, Staff recommends that the increase in the rent expense be based on the absolute lowest rate included in the rental listing provided by Bluegrass, which is \$5.10 per square foot/year. That will result in office rent expense of \$10,710 per year, which will require including an adjustment to increase Bluegrass's test-year office rent expense by \$7,710.

e. Repairs and Maintenance Expense. Bluegrass's test-year expense for repairs and maintenance was \$9,543, which it proposed to increase by \$7,500. In its application, Bluegrass stated that its five-year average for this account was \$6,000 and that the 2010 expense was greater than normal due to unexpected repairs. It requested the \$7,500 increase to repair regulators, meters, and other equipment on which work had been postponed due to Bluegrass's budgetary constraints of recent years.

Staff requested that Bluegrass provide a list of specific repairs and maintenance work that had been postponed plus estimates from contractors of the cost to make the postponed repairs. In response to Staff's request, Bluegrass did not provide such a list, however, it described its need to either purchase or lease a backhoe rather than rent one as it has done historically and does currently. It stated that having its own backhoe would allow for repairs to be made in a timelier manner than when it rents equipment. Bluegrass provided a list of prices of new and used backhoes and stated that if it could purchase or lease a used backhoe in a price range of \$30,000 to \$40,000, it could finance or lease the equipment for five years at a cost of approximately \$7,500 annually.

It is not the Commission's practice to permit "possible" future financings to be included in the determination of a utility's revenue requirement. Financing the purchase of equipment over a period longer than two years requires Commission pre-approval pursuant to KRS 278.300. Until it has authorized a financing proposal of a utility, the Commission does not permit recovery of the costs related thereto. For that reason, it is Staff's recommendation that no adjustment be made to the test-year expense of \$9,543.

f. Insurance – Health. In the 2010 test year, Bluegrass incurred expenses of \$25,990 for employee health insurance. It proposed an adjustment to increase this expense by \$1,300 based on the general level of increases it has experienced in recent years. Bluegrass stated that the size of its insurance plan, based on the small number of employees covered, attributed to the size of the increases it has experienced.

Effective June 1, 2011, Bluegrass's office manager/bookkeeper became an employee of Home Office. This did not change her job duties or compensation and the costs Home Office incurs for her compensation are billed to Bluegrass. However, this change resulted in her being covered under Home Office's larger health insurance plan rather than the Bluegrass plan. This change, with the health insurance costs of the office manager/bookkeeper included as an expense of Bluegrass, resulted in a decrease in Bluegrass's monthly health insurance costs of approximately \$100. Based on this result, Staff recommends an adjustment to decrease Bluegrass's cost for health insurance by \$1,200 annually, as compared to its proposed increase of \$1,300.

g. Truck Maintenance/Gasoline Expense. Bluegrass's test-year expense for Truck Maintenance/Gasoline Expense was \$19,885. Based on increasing prices in the months after its test year, Bluegrass proposed an increase of \$3,000 (approximately 15

percent) to its test-year expense. Staff's review of gasoline prices since the end of Bluegrass's 2010 test year, January 2011 - May 2012, as reported by the New York Mercantile Exchange, indicates that gasoline prices increased over most of the first half of 2011 and fell during the second half of the year. Prices began to increase again in January 2012, peaked in March 2012 at nearly the same level as was last reached in May 2011, and have declined over the period of time since then. In the most recent 12-month period, prices ranged between \$2.42 and \$3.48 per gallon with an average of \$2.89 per gallon. Compared to the average price for calendar 2010 of \$2.47 per gallon, this most recent 12-month average reflects an increase of 17 percent.

Of the \$19,885 expense amount, \$14,364 was for gasoline and \$5,521 was for vehicle maintenance. Applying a 17 percent increase to the cost for gasoline increases that amount by \$2,442, to a total of \$16,806. The Staff recommends that an adjustment to increase the amount of the test-year expense for Truck Maintenance/Gasoline be made in the amount of \$2,442, which results in a pro forma expense of \$22,327.

h. PSC Assessment. For the test year, Bluegrass reported \$2,724 as the amount of its assessment by the Public Service Commission ("PSC Assessment"). It proposed an adjustment to increase this amount by approximately 9 percent, or \$250, to \$2,974, to reflect the potential increase in its revenues due to this rate case. As the test-year amount appeared to be greater than it should have been based on Bluegrass's revenue and the relevant assessment rate, Staff inquired about this matter to ascertain whether two years of assessments might have been recorded in 2010. That inquiry caused Bluegrass to review its accounting records which revealed that the \$2,724 consisted of one year's PSC Assessment and one year's public service company state

property tax payment, including a late penalty. The 10 percent late penalty of \$164 should be treated as a non-recurring expense; accordingly, Staff recommends reducing the test-year expense by that amount, from \$2,724 to \$2,560. Based on the increase Staff is recommending in Bluegrass's revenues, it has recognized an adjustment of \$250, which increases the reduced test-year expense from \$2,560 to \$2,810. On the accompanying income statement, this is shown as an \$86 increase, the net of the \$164 decrease for the late penalty and the \$250 increase based on Staff's recommended revenue increase.

i. Professional Fees. Bluegrass's test-year expense for professional fees was \$7,160. The full amount was for legal services related to various issues, including the preparation of its application in this proceeding. It proposed a \$6,000 adjustment to increase this expense to \$13,160, stating that this was based on increased needs for ongoing regulatory, financial, and other services. Invoices provided by Bluegrass and its response to Staff's inquiry indicated that a majority of the pro forma amount of \$13,160 was related to this case. The breakdown shows that \$7,500 is rate case-related while \$5,660 is related to other ongoing legal services.

As was discussed with Home Office's representative during Staff's on-site visit, the Commission typically recognizes the costs a utility incurs for professional services in conjunction with a rate case and allows recovery of those costs based on a three-year amortization period. In this instance, a three-year amortization of the \$7,500 in legal fees related to this case results in an annual amount of \$2,500. Adding this amount to the \$5,660 for ongoing legal services produces a total amount of \$8,160, which is \$1,000 more than the test-year expense of \$7,160. Accordingly, Staff recommends that

an adjustment to increase professional fees by \$1,000 be made and that \$8,160 be included in Bluegrass's pro forma operating expenses.

j. Bad Debt Expense. During the test year, Bluegrass incurred bad-debt expense of \$3,504, slightly less than what it identified as its five-year average of nearly \$3,700 (it stated that it had a one-year spike in 2005). It proposed an adjustment to increase its bad-debt expense by \$500, to \$4,004, due to current economic conditions.

Staff's review of Bluegrass's historical bad-debt expense revealed that its five-year average for 2006-2010 was \$2,272. If the historical period is extended for six years to include 2005, the year it experienced a spike of \$10,471, the result is nearly \$3,700, the amount it indicated was its five-year average. Staff's review shows that, based on the annual revenues and Mcf sales reported in Bluegrass's annual report for 2005, the year of the spike in its bad-debt expense, the average price to its customers was \$14.78 per Mcf. In the test year, the average price to its customers was \$8.69 per Mcf. Economic conditions were better in 2005 than in 2010, but Bluegrass's bad-debt expense in 2005 was approximately three times its 2010 bad debt expense. It appears that the price per Mcf, and its impact on customers' bills, has had a stronger influence on Bluegrass's bad-debt expense than have economic conditions. With no clear link between economic conditions and its bad-debt expense, Staff recommends that no adjustment be made to Bluegrass's test-year bad-debt expense.

k. Income Taxes. As a Sub-Chapter S corporation, Bluegrass is not required to pay corporate income taxes. However, in patterning its application after the recent filing by another small gas distribution company, it included income taxes when it multiplied its Required Net Operating Income by the same Tax Gross-up Factor used by

the other utility. Because of its Sub-Chapter S status, Bluegrass is not liable for income taxes, therefore, corporate income taxes are not included in Staff's determination of Bluegrass's revenue requirement.

Bluegrass also included in its revenue requirement its shareholders' taxes on the estimated income resulting from its proposed increase in rates. The Commission has previously found that the income tax liability of shareholders is the responsibility of the shareholders.¹⁰ That is the case regardless of whether a utility is a Sub-Chapter S corporation or Sub-Chapter C corporation. Therefore, the Commission does not include a provision for income taxes when calculating the revenue requirement of a utility that is formed as a Sub-Chapter S corporation. Absent persuasive evidence to the contrary, Staff will not recommend a departure from the Commission's prior position on this issue.

Determination of Revenue Requirement

With its recommended adjustments, Staff calculated non-gas test-year operating expenses of \$296,567. Applying a 88 percent operating ratio results in required net operating income of \$40,441. Adding the adjusted operating expenses of \$296,567 and the adjusted interest expense of \$15,200 produces a total revenue requirement of \$352,208. After deducting \$5,633 of other operating revenues, the amount of revenues required to be generated from Bluegrass's base rates is \$346,575.

¹⁰ Case No. 2006-00171, Application of Cow Creek Gas, Inc. for Authority to Adjust Its Rates Pursuant to the Alternative Rate Filing Procedure for Small Utilities (Ky. PSC June 8, 2006). See also the Commission Staff's Report in Case No. 2009-00227, Alternative Rate Filing Application of Middletown Waste Disposal, Inc. (Ky. PSC Apr. 1, 2010).

Conclusion

There being no other adjustments, this concludes the discussion of Bluegrass's revenue requirement. The rates recommended by Staff are shown in Appendix D of this report.

APPENDIX D
STAFF REPORT, CASE NO. 2011-00364
STAFF'S RECOMMENDED
RATES AND CHARGES

BASE RATES W/O SALARIES & WAGES AND PAYROLL TAXES INCREASE

<u>RATE CLASSIFICATION</u>	<u>BASE RATE</u>
Customer Charge	\$ 10.00
Per Mcf Charge	\$ 4.9708
 <u>GAS COST</u>	
Per Mcf Charge	\$ 5.0706

BASE RATES WITH SALARIES & WAGES AND PAYROLL TAXES INCREASE

<u>RATE CLASSIFICATION</u>	<u>BASE RATE</u>
Customer Charge	\$ 10.00
Per Mcf Charge	\$ 5.1416
 <u>GAS COST</u>	
Per Mcf Charge	\$ 5.0706

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